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PART VI

# COST ACCOUNTING STANDARDS BOARD

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# COST ACCOUNTING STANDARDS

## Indirect Cost Allocation

[1620-01]

## COST ACCOUNTING STANDARDS BOARD

[4 CFR Parts 417, 418, 419, 420, 421]

## COST ACCOUNTING STANDARDS

### Indirect Cost Allocation

AGENCY: Cost Accounting Standards Board.

ACTION: Proposed rule.

SUMMARY: The Board is proposing five Standards which would deal with the allocation of various indirect costs. When adopted the Standards will apply to negotiated national defense contracts subject to Pub. L. 91-379. The Standards are the result of an extensive study which the Board has undertaken as part of its responsibility to achieve uniformity and consistency in the cost accounting principles to be followed by defense contractors and subcontractors under Federal contracts.

DATE: Comments are due July 17, 1978.

FOR FURTHER INFORMATION CONTACT:

Arthur Schoenhaut, Executive Secretary, Cost Accounting Standards Board, 441 G Street NW., Washington, D.C. 20548, 202-275-6111.

SUPPLEMENTARY INFORMATION: For some time the Cost Accounting Standards Board has had underway a comprehensive project to deal with the allocation of direct and indirect costs to cost objectives. After extensive research the five proposed Standards being published today have been developed. The Standards deal with various aspects of indirect costs as indicated by the following table.

| Type of indirect cost pool | Purpose of the pool | Appropriate allocation measure(s) |
|---|---|---|
| Service center | Accumulates indirect costs relating to provision of services. | Generally a consumption measure or an output measure; when lacking both, a surrogate. |
| Overhead pool | Accumulates indirect costs relating to the measurement of production-related functional activities. | A broad-based measure such as total direct labor hours representative of management activities relating to production. |
| Business unit G&A expenses | Accumulates indirect costs relating to overall management activities. | A broad-based measure such as total cost input relevant in the contest of overall management activities related to the business unit. |
| Other | Accumulates those indirect costs not covered by any other specific cost accounting standard. | A hierarchy of allocation measures in descending order of preferability. |

The five Standards being proposed involve the following:

#### Cost Accounting Standard 417—Distinguishing Between Direct and Indirect Costs

Cost Accounting Standard 417 provides criteria for consistency in determining which costs shall be specifically identified with and allocated to the final cost objectives of a period, as direct costs. It requires that all costs that satisfy these criteria must be accounted for as direct costs. It provides generally that costs not meeting the criteria for a direct cost shall be classified as indirect and be grouped in homogeneous indirect cost pools for allocation to cost objectives in accordance with the requirements of other Cost Accounting Standards and the contractor's disclosed or established cost accounting practices.

#### Cost Accounting Standard 418—Allocation of Service Center Costs

Cost Accounting Standard 418 provides a hierarchy of measures for the allocation of service center costs. In descending order of preferability the allocation measures are: (1) a resource consumption measure, (2) an output measure, and (3) a surrogate that is representative of resources used. CAS 418 allows the use of standard costs in allocating service center costs. It also provides guidelines in allocating such service center costs among service centers.

#### Cost Accounting Standard 419—Allocation of Material-Related Overhead Costs

Cost Accounting Standard 419 provides for accumulating the material-related overhead costs of a business unit into at least one overhead pool. The material-related overhead pool(s) will be allocated to final cost objectives and other specified cost objectives using a measure expressed in terms of either direct material cost or a physical characteristic of direct materials. The proposed Standard gives guidance for the number and type of overhead pools to be established. However, a single overhead pool is permitted provided substantially the same allocation results as would result if several pools were used.

#### Cost Accounting Standard 420—Allocation of Manufacturing, Engineering, and Comparable Overhead Costs

Cost Accounting Standard 420 provides for accumulating all overhead costs, except material-related overhead costs, in three types of pools. The types of pools to be established are determined by application of the criteria provided in the Standard to a business unit's production circumstances. The proposed Standard provides for allocation of overhead costs to final cost objectives and other specified cost objectives. It also establishes the criteria concerning the selection and composition of the allocation bases.

#### Cost Accounting Standard 421—Allocation of Indirect Costs

Cost Accounting Standard 421 provides that when items of indirect cost are not specifically covered by any other Cost Accounting Standard, CAS 421 governs the accumulation of costs in indirect cost pools and the selection of allocation measures based on the beneficial or causal relationship. The Standard provides for guidance in determining the homegeneity of an indirect cost pool, and establishes a hierarchy of allocation measures: (1) a measure of resource consumption, (2) an output measure, (3) a surrogate for consumption or output, or (4) a measure representative of the benefiting activities.

Interested parties have suggested to the Board that comments on any Standards in this area could be better prepared if all the Standards currently being proposed to cover this cost accounting area were published together. The Board believes that this suggestion has merit. Consequently, it has delayed publication of several of these Standards until this time. It has also been suggested to the Board that Standards resulting from this proposal should have the same effective date. Such action, the Board has been advised, will simplify the implementation process significantly. The Board's research indicates that this suggestion also has merit. Therefore it is intended that all promulgations which result from this proposal will be published at the same time and will have a common effective date.

The Board recognizes that the five proposed Standards which represent a major undertaking by the Board involve complex accounting matters. Analysis by those interested in submitting comments on the proposals is likely to require more than the ordinary length of time. In recognition of this, the Board has determined that an extended period of time should be allowed for comment. Therefore, the due date for comments on these pro-

posals has been established as July 17, 1978. Interested parties are invited to submit written comments by that date. All written comments made pursuant to this notice will be made available for public inspection at the Board's office during regular business hours.

In order to facilitate analysis by both the Board and members of the public, those who comment are urged to separate comments relating to individual Standards from their general evaluations. Commentators are also urged to submit any data regarding any increases or decreases in costs that might result from thse Standards and whether any such increases or decreases would be one-time or continuing. Such data together with other comments will assist the Board in evaluating the proposed costs of implementation of the Standards, including inflationary effects if any, and the probable benefits including advantages and improvements in the pricing, the administration, and the settlement of contracts. Information on costs, inflationary effects, and benefits may be submitted on the basis of either a Standard by Standard analysis or an evaluation of all five Standards as a unit.

It is proposed to add new parts 417, 418, 419, 420, and 421 to read as follows:

## PART 417—DISTINGUISHING BETWEEN DIRECT AND INDIRECT COSTS

Sec.
417.10 General applicability.
417.20 Purpose.
417.30 Definitions.
417.40 Fundamental requirement.
417.50 Techniques for application.
417.60 Illustrations.
417.70 Exemptions.
417.80 Effective date.

AUTHORITY: Sec. 719 of the Defense Production Act of 1950, as amended, Pub. L. 91-379, 50 U.S.C. App. 2168.

### § 417.10 General applicability.

General applicability of this Cost Accounting Standard is established by section 331.30 of the Board's regulations on applicability, exemption, and waiver of the requirement to include the Cost Accounting Standards contract clause in negotiated defense prime contracts and subcontracts (4 CFR 331.30).

### § 417.20 Purpose.

The purpose of this Cost Accounting Standard is to provide criteria for distinguishing direct costs from indirect costs based on the relationship of costs to final cost objectives.

### § 417.30 Definitions.

(a) The following are definitions of terms prominent in this Standard:

(1) *Allocate.* To assign an item of cost, or a group of items of cost, to one or more cost objectives. This term includes both direct assignment of cost and the reassignment of a share from an indirect cost pool.

(2) *Cost objective.* A function, organizational subdivision, contract, or other work unit for which cost data are desired and for which provision is made to accumulate and measure the cost of processes, products, jobs, capitalized projects, etc.

(3) *Direct cost.* Any cost which is identified specifically with a particular final cost objective. Direct costs are not limited to items which are incorporated in the end product as material or labor. Costs identified specifically with a contract are direct costs of that contract. All costs identified specifically with other final cost objectives of the contractor are direct costs of those cost objectives.

(4) *Final cost objectives.* A cost objective which has allocated to it both direct and indirect costs, and, in the contractor's accumulation system, is one of the final accumulation points.

(5) *Indirect cost.* Any cost not directly identified with a single final cost objective, but identified with two or more final cost objectives or with at least one intermediate cost objective.

(6) *Indirect cost pool.* A grouping of incurred costs identified with two or more cost objectives but not identified with any final cost objective.

### § 417.40 Fundamental requirement.

(a) A cost shall be accounted for as a direct cost and be allocated only to the final cost objective with which it is identified if:

(1) The beneficial or causal relationship between the incurrence of the cost and the final cost objective is clear and exclusive; and,

(2) The amount of the cost identified with a resource used directly on or applied directly to the final cost objective is readily and economically measurable without undue administrative effort; and,

(3) All other costs incurred for the same purpose in like circumstances can also be identified specifically with particular final cost objectives and accounted for as direct costs in compliance with 4 CFR 402.

(b) Costs which do not satisfy the criteria of (a) above shall be identified and accounted for as indirect costs, and grouped in homogeneous indirect cost pools for allocation to cost objectives in accordance with applicable Cost Accounting Standards and the contractor's disclosed or established cost accounting practices.

### § 417.50 Techniques for application.

(a) (1) The beneficial or causal relationship between the incurrence of a cost and a final cost objective shall be deemed to be clear and exclusive if the unit of labor, material, or other type of resource (resource) with which that cost is identified is used on or applied to that final cost objective and that resource is separable from resources used on other cost objectives.

(2) Costs identified with a resource used directly on or applied directly to a final cost objective shall be limited to the costs of that resource that vary directly with its consumption.

(b) Where the units of a resource used directly on or applied directly to final cost objectives are interchangeable, and the cost of that resource meets the requirements of § 417.40(a), the amount of cost to be allocated to particular final cost objectives may be determined on the basis of an average cost of the units used or applied. Costs accounted for in this manner are direct costs.

(c) Costs allocated to final cost objectives from a service center shall be treated as other direct costs of those final cost objectives.

(d) Costs incurred in the production of goods for multiple final cost objectives may be accumulated in an intermediate cost objective and be allocated to the final cost objectives receiving the output of that production on the basis of a cost per unit of such output. Costs accounted for in this manner shall be treated as direct costs of the final cost objectives.

(e) Direct costs of minor dollar amount may be accounted for as indirect costs as provided for in 4 CFR 402.50(e)

### § 417.60 Illustrations.

(a) Contractor A has various classifications of engineers whose time is spent in working directly on the production of the goods or services called for by contracts and other final cost objectives. The circumstances under which they work are such that it is practical and economical to keep detailed time records of all work performed by these engineers, and to report all hours worked against pre-established job/account numbers representing particular cost objectives. On the basis of these detailed time reports, Contractor A allocates the labor costs of these engineers as direct labor costs of final cost objectives. This practice is in compliance with the requirements of § 417.40(a).

(b) Contractor B has personnel who work on budgets, job cost analyses, and reports, under circumstances in which their time cannot practically and economically be identified with particular final cost objectives on a consistent basis. Contractor B accounts for the labor costs of these employees as indirect costs in accordance with his established cost accounting practices. This is in compliance with the requirements of § 417.40(b).

(c) Contractor C has a paint shop, employees of which spray-paint units of the work-in-process of multiple final cost objectives. These employees are grouped in homogeneous groupings, and records are maintained of the time spent by each employee on the work identified with particular final cost objectives. An average wage rate is established for each group. These average rates are applied consistently covering all of the spray-painting work performed by all employees in each group. The resultant costs are allocated as direct labor costs to each final cost objective. This cost accounting treatment is in compliance with the provisions of § 417.50(b).

(d) Contractor D has a shop in which units of material for various final cost objectives are painted. The labor performed by employees working on material for final cost objectives meets the clear and exclusive test set out in § 417.50(a)(1), and can be specifically identified with the individual final cost objectives. Also, the costs of that labor satisfy all requirements of § 417.40(a). The contractor charges the costs of the paint shop as direct labor costs of the final cost objectives worked on, by means of a rate that includes not only the labor costs, but also the costs of materials, and other costs of the paint shop. This rate is based on the hours of direct labor performed by the shop. Section 417.40(a) requires that the labor costs be allocated to the final cost objectives worked on. Further, in accordance with § 417.50(a)(2), the direct labor costs charged to the FCO's can include only the costs of the labor resource and cannot include materials and other costs of the paint shop. Contractor D's practices are not in compliance with CAS 417.

(e) Contractor E has a plating shop, but is not able to readily and economically identify the labor time spent on particular final cost objectives. Contractor E therefore establishes the plating shop as a service center, the composite labor, material, and other costs of which are allocated to final cost objectives based on a measurement of output, and are treated as other direct costs. This practice is in accordance with the provisions of § 417.50(c).

(f) Contractor F uses a process cost system in the production of parts and components which are to be used on multiple final cost objectives. The accumulated labor, material, and other costs of each process are identified with the output of that process on the basis of a composite cost per unit of such output. The costs thus identified with particular units of output are subsequently allocated from the process cost center as direct costs of the individual final cost objectives with which the output is specifically identified. This practice is in compliance with § 417.50(d).

**§ 417.70 Exemptions.**

None for this Standard.

**§ 417.80 Effective date.**

(a) The effective date of this Standard is [reserved].

(b) This Standard shall be followed by each contractor on or after the start of his next cost accounting period beginning after the receipt of a contract to which this Cost Accounting Standard is applicable.

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## PART 418—COST ACCOUNTING STANDARD ALLOCATION OF SERVICE CENTER COSTS

Sec.

418.10 General applicability.
418.20 Purpose.
418.30 Definitions.
418.40 Fundamental requirement.
418.50 Techniques for application.
418.60 Illustrations.
418.70 Exemptions.
418.80 Effective date.

AUTHORITY: Sec. 719 of the Defense Production Act of 1950, as amended, Pub. L. 91-379, 50 U.S.C. App. 2168.

**§ 418.10 General applicability.**

General applicability of this Cost Accounting Standard is established by section 331.30 of the Board's regulations on applicability, exemption, and waiver of the requirement to include the Cost Accounting Standards clause in negotiated defense prime contracts and subcontracts (4 CFR 331.30).

**§ 418.20 Purpose.**

The purpose of this Cost Accounting Standard is to provide criteria for the allocation of service center costs to other cost objectives based on the beneficial or causal relationship between such costs and those cost objectives. Consistent application of these criteria will improve cost allocation.

**§ 418.30 Definitions.**

(a) The following are definitions of terms prominent in this Standard.

(1) *Indirect cost.* Any cost not directly identified with a single final cost objective, but identified with two or more final cost objectives or with at least one intermediate cost objective.

(2) *Indirect cost pool.* A grouping of incurred costs identified with two or more cost objectives but not identified specifically with any final cost objective.

(3) *Service center.* An intermediate cost objective which accumulates cost of services provided to other cost objectives, which services can be identified specifically with such other cost objectives.

(4) *Standard cost.* Any cost computed with the use of pre-established measures.

**§ 418.40 Fundamental requirement.**

Service center costs shall be allocated to cost objectives in reasonable proportion to the beneficial or causal relationship of the service center to those cost objectives, by means of one of the following bases of allocation, listed in the descending order of preferability: (1) a resource consumption measure, (2) an output measure, or (3) a surrogate that is representative of resources used.

**§ 418.50 Techniques for application.**

(a) *Selection of allocation measures for a service center.* (1) Where two or more types of resources are consumed in the course of providing services, and where the consumption of these resources tends to be proportional with respect to a single measure, that single measure may be used as the consumption measure of the service center, and serve as the basis of allocation of costs of the service center.

(2) Where consumption measures are unavailable or impractical to ascertain, the basis of allocation may be a measurement of the output of the service center. Output is measured in terms of units of end product produced by the service center, such as the number of printed pages for a print shop.

(3) Where both consumption measures and output measures are unavailable or impractical to ascertain, the basis of allocation shall be a measure of the activity of the cost objectives receiving services from the service center; this measure, a surrogate, shall be representative of the resource consumption or of the output of the service center.

(4) Where a service center provides a number of services of different value of magnitude and the use of a single allocation measure does not adequately reflect the proportional consumption of resources, more than one measure shall be used. Each such measure shall be representative of the cost of the resources consumed to perform the services rendered.

(5) Where two or more cost objectives receive services simultaneously, the measure of consumption or of output during such simultaneous performance of service shall be prorated between or among these cost objectives.

(b) *Composition of costs of a service center.* Costs of a service center shall include both: (i) costs incurred by the sservice center, and (ii) costs allocated to it.

(c) *Use of standard costs.* (1) Where: (i) The total cost of a service center for a cost accounting period is pre-established, and (ii) the total quantity of

services to be provided in a cost accounting period is pre-esbablished, the resulting computation is a standard cost. Standard costs may be used in allocation costs of a serivce center.

(2) Where standard costs are in use in allocating costs of a service center, and where variances of a cost accounting period are material, these variances shall be disposed of by allocating to benefiting cost objectives in proportion to standard costs initially allocated to these cost objectives.

(d) *Allocation of costs among service centers.* (1) Allocation of costs from a service center to other service centers shall be made when the cost of services provided is significant and when the allocation results in a materially different allocation of cost to final cost objectives.

(2) Allocation of costs among service centers may be accomplished either: (i) by allocating costs of services provided to and received from other service centers (often called the cross-allocation or reciprocal method), or (ii) by allocation costs from service centers to other service centers in a predetermined order (often called the sequential method).

(3) When the allocation from service centers to other service centers is made in a predetermined order, a service center whose costs have already been allocated receives no further allocation from other service centers. The order of allocation shall be established to minimize the effect of not allocating costs to those service centers whose costs had been previously allocated. This order of allocation shall be established by allocating first the costs of service centers which generally receive the smallest amount of costs from other service centers and allocating last those service centers which generally receive the largest amount of costs from other service centers.

(e) *Frequency of cost allocation or standard-cost revision.* (1) Costs of service centers shall be allocated on an annual basis.

(2) Where standard costs are used to allocate the cost of a service center, such standard costs shall reflect the anticipated cost for the cost accounting period. Such standard costs shall be reviewed at least annually, and revised as necessary to reflect the anticipated conditions. The revised standard costs shall be made effective after the variances have been disposed of as provided for in paragraph (c)(2) above.

**§ 418.60 Illustrations.**

(a) Contractor A accounts for the costs of its wind tunnel as a service center. Three major types of resources are generally consumed in the course of providing wind-tunnel services to specific cost objectives: (1) the wind tunnel itself, (2) power in running the wind tunnel, and (3) engineers' and operators' services in observing and recording the test results. Contractor A establishes: (1) that a single measure, the machine hour of the wind-tunnel, adequately reflects the consumption of the wind-tunnel resource, and (2) that the consumption of the other two major types of resources tends to be proportional with respect to that single measure. Contractor A selects the wind-tunnel machine hour as the consumption measure of the wind-tunnel service center. Contractor A's practice is in conformance with provisions of § 418.50(a)(1).

(b) Contractor B accounts for the costs of its technical typing services as a service center. In the course of selecting an allocation measure for this service center, Contractor B establishes that consumption measures are unavailable and impractical to ascertain, and decides on using the number of typed pages as allocation measure. Contractor B's approach to selecting an allocation measure and its selection of the number of typed pages, an output measure, as the allocation measure are in conformance with provisions of § 418.50(a)(2).

(c) Contractor C makes use of an on-line material-cost and labor-cost entry and reporting system, whereby such data are transmitted from terminals located in various production departments to a centralized computer installation. It accounts for the cost of this system as a service center. In the course of selecting an allocation measure for this service center, Contractor C established that consumption measures are unavailable and impractical to ascertain, on the ground that numerous entries are made during each day, each entry requiring only a few seconds of access time. It also establishes that output measures are also unavailable and impractical to ascertain, since the number of departmental cost reports is unrelated to the number of entries initiated from various production departments. Contractor C selects the number of entries made by each production department as the allocation measure, and establishes that this measure, a surrogate, is representative of the resource consumption of this service center. Contractor C's practice is in conformance with provisions of § 418.50(a)(3).

(d) Contractor D accounts for the costs of its data processing operations as a service center. Three major types of services are provided by the data-processing service center: (1) systems analysis and applications programming, (2) central processing unit operations, and (3) off-line printer operations. Some users require strong analysis and programming support, some other users make almost exclusive use of the central processing unit, while still other users require heavy use of the off-line printer. Unable to find a single measure that adequately reflects the proportional consumption of resources associated with the three types of services, Contractor D selects three measures: (1) analysts' and programmers' manhours for the first type of services, (2) central processing unit time for the second, and (3) pages of printout for the third. Contractor D's practice is in conformance with provisions of § 418.50(a)(4).

(e) Contractor E accounts for the costs of its company aircraft as a service center, and selects the number of flight hours, a consumption measure, as the allocation measure. At the end of each trip, Contractor E prorates the flight hours whenever simultaneous services have been rendered, using the flight logbook as the basis, as shown in the following schedule:

| Trip No. | Flight hours | Number of passengers by cost objective | | | | Flight hours by cost objective | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | *A* | *M* | *N* | *Z* | *A* | *M* | *N* | *Z* |
| 1 | 10 | 3 | | | | 10 | | | |
| 2 | 20 | | 2 | 1 | 1 | | 10 | 5 | 5 |
| 3 | 15 | 2 | | 4 | | 5 | | 10 | |
| 4 | 25 | | | | 3 | | | | 25 |

Contractor E's practices are in conformance with provisions of § 418.50 (a)(1) with respect to the selection of allocation measures, and § 418.50(a)(5) with respect to the proration of measures when simultaneous services are involved.

(f) Contractor F maintains a wind tunnel as a service center. It includes depreciation and occupancy costs of the wind tunnel in the engineering overhead pool, and includes other costs relating to the operation of the wind tunnel in the service center. Contractor F's practice is in violation of § 418.50(b), since not all costs incurred by the service center have been included in the service center.

(g) Contractor G allocates costs of its aircraft service center by means of a standard cost based on flight hours. For Year 197X, it budgets the cost of the aircraft service at $300,000, and forecasts the number of flight hours at 1,500 hours, thereby setting a standard cost of $200 per flight hours. During the year, hours of flight time used by, and costs allocated to, cost objectives using the aircraft are as follows:

| Cost objectives | Hours flown | Costs allocated |
|---|---|---|
| Service center A | 500 | $100,000 |
| Overhead pool M | 100 | 20,000 |
| Overhead pool N | 200 | 40,000 |
| Contract Z | 400 | 80,000 |
| Total | 1,200 | 240,000 |

Actual costs of the aircraft service center for year 197X amounts to $390,000, and result in an unfavorable variance of $150,000. Since the variance is material, Contractor G disposes of it by allocating to the above cost objectives as follows:

| Cost objectives | Costs initially allocated | Percentage | Amount of variance of $150,000 allocated |
|---|---|---|---|
| Service center A | $100,000 | 41⅔ | $62,500 |
| Overhead pool M | 20,000 | 8⅓ | 12,500 |
| Overhead pool N | 40,000 | 16⅔ | 25,000 |
| Contract Z | 80,000 | 33⅓ | 50,000 |
| Total | 240,000 | 100 | 150,000 |

Contractor G's practice is in compliance with provisions of § 418.50(c)(2). It shall also review the standard cost, and revise it as needed, for the following cost accounting period in accordance with provisions of § 418.50(e)(2).

(h) Contractor H maintains five service centers, each of which provides services to other service centers and to other cost objectives. Contractor H allocates none of the costs of each of these service centers to other service centers, but allocates all of these costs only to other cost objectives. This practice is not in accordance with provisions of § 418.50(d)(2), unless Contractor H can demonstrate that its practice does not result in a materially different allocation of cost to final cost objectives, as provided for in § 418.50(d)(1).

**§ 418.70 Exemptions.**

None for this Cost Accounting Standard.

**§ 418.80 Effective date.**

(a) The effective date of this Standard is [reserved].

(b) This Standard shall be followed by each contractor on or after the start of his next cost accounting period beginning after the receipt of a contract to which this Cost Accounting Standard is applicable.

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## PART 419—ALLOCATION OF MATERIAL-RELATED OVERHEAD COSTS

Sec.
419.10 General applicability.
419.20 Purpose.
419.30 Definitions.
419.40 Fundamental requirement.
419.50 Techniques for application.
419.60 Illustrations.
419.70 Exemptions.
419.80 Effective date.

AUTHORITY: Sec. 719 of the Defense Production Act of 1950, as amended, Pub. L. 91-379, 50 U.S.C. App. 2168.

**§ 419.10 General applicability.**

General applicability of this Cost Accounting Standard is established by Section 331.30 of the Board's regulations on applicability, exemption, and waiver of the requirement to include the Cost Accounting Standards contract clause in negotiated defense prime contracts and subcontracts (4 CFR 331.30).

**§ 419.20 Purpose.**

The purpose of this Cost Accounting Standard is to provide criteria for accumulating material-related overhead costs, and for allocating the costs thus accumulated to final cost objectives and other specified cost objectives of the business unit based on the beneficial or causal relationship between such costs and such cost objectives. Consistent application of these criteria will improve cost allocation.

**§ 419.30 Definitions.**

(a) The following are definitions of terms prominent in this Standard.

(1) *Allocate.* To assign an item of cost, or a group of items of cost, to one or more cost objectives. This term includes both direct assignment of cost and the reassignment of a share from an indirect cost pool.

(2) *Business unit.* Any segment of an organization, or an entire business organization which is not divided into segments.

(3) *Final cost objective.* A cost objective which has allocated to it both direct and indirect costs, and, in the contractor's accumulation system, is one of the final accumulation points.

(4) *Material-related overhead cost.* An indirect cost related to an activity or group of activities for acquiring, handling, or controlling of required materials, until the materials are used or consumed in the production of goods and services or are sold without processing.

(5) *Overhead pool.* A cost pool used to accumulate the indirect costs of a productive function or productive activity.

**§ 419.40 Fundamental requirement.**

(a) When material-related overhead costs of a business unit are material in amount, they shall be grouped in at least one separate material-related overhead pool for allocation to final cost objectives and other cost objectives as set forth in § 419.50(d)(1). More than one overhead pool is necessary where the material-related overhead costs in a single pool are not allocated in reasonable proportion to the use of the separate material-related functions by the final cost objectives and other specified cost objectives.

(b) The material-related overhead costs shall be allocated by means of a base which allocates the costs in reasonable proportion to their beneficial or causal relationships to the final cost objectives and other specified cost objectives.

**§ 419.50 Techniques for application.**

(a) *Composition of a pool.* (1) A material-related overhead pool shall include (i) costs specifically identified with a material-related function, (ii) costs allocated to a material-related function from other indirect cost pools, (iii) purchase price adjustments which are accounted for as indirect costs in accordance with 4 CFR 411.50(a), and (iv) direct material inventory adjustments accounted for as indirect costs.

(2) Expenses of a home office associated with material-related functions which are separately allocated to a segment shall be included in the segment's material-related overhead pool.

(3) Nonmaterial-related costs which can be appropriately allocated by one of the bases set forth in paragraph (c) below may be included with a material-related overhead pool for allocation to cost objectives.

(b) *Number and type of pools.* A single material-related overhead pool may be used where the costs can be allocated to cost objectives in reasonable proportion to the use of the separate material-related functions by the cost objectives. Where the cost allocations are not in reasonable proportion to such use, more than one overhead pool shall be established. In determining the number of overhead pools to establish, the contractor shall consider the use of the separate material-related functions by the cost objectives, the significance of the costs that would be included in each overhead pool, and the significance of the differences in allocations to cost objectives.

(c) *Selection and Composition of Allocation Base.* (1) The allocation base

that reflects a beneficial or causal relationship between the pool of costs and the final cost objectives during a typical cost accounting period shall be expressed in terms of either the direct material costs, as measured by 4 CFR 411.50(a) and (b), or a physical characteristic of direct material, such as number of units, weight or volume. A factor representing items of acquired materials or services shall be included in an allocation base where such items benefit from or cause a significant portion of the costs in a material-related overhead pool.

(2) If a contractor receives significant amounts of Government-furnished or customer-furnished material for use in performing work on final cost objectives, such circumstances shall be considered in determining the allocation base.

(i) Where a direct material cost base is used and the contractor and contracting officer agree on the value of the Government-furnished or customer-furnished material, such value shall be included in the base. Where a value cannot be agreed upon, a direct material cost base may be used only when it would not significantly distort the allocation of the cost pool to final cost objectives.

(ii) Where the contractor cannot find an appropriate allocation base for a cost pool established in accordance with paragraph (b) above, the contractor may make a special allocation of the material-related overhead costs associated with Government-furnished or customer-furnished materials to final cost objectives. The amount of the special allocation shall be excluded from all material-related overhead pools and the measure, if any, representing the Government-furnished or customer-furnished materials shall be excluded from the base used to allocate these pools.

(d) *Allocation to cost objectives.* (1) Material-related overhead costs shall be allocated to the following cost objectives:

(i) Final cost objectives.

(ii) Goods produced for stock or product inventory.

(iii) Independent Research and Development and Bid and Proposal projects.

(iv) Cost centers used to accumulate costs identified with a process cost system (i.e., process cost centers).

(v) Goods or services acquired or produced, or both, for other segments of the contractor, for other cost objectives or service centers of a business unit.

(vi) Construction, fabrication, betterment, improvement or installation of tangible capital assets.

(2) Where a particular final cost objective in relation to other final cost objectives receives significantly more or less benefit from material-related overhead costs than would be reflected by the allocation of such costs using a base determined pursuant to paragraph (c) of this section, the business unit shall account for this particular final cost objective by a special allocation from the material-related overhead pool(s) to the particular final cost objective commensurate with the benefits received. The amount of a special allocation to any such final cost objective shall be excluded from the material-related overhead pool(s) and the particular final cost objective's allocation base data shall be excluded from the base used to allocate this pool(s).

(3) Where predetermined rates are used in allocating material-related overhead costs, significant amounts of variances of a cost accounting period shall be allocated to the benefiting final cost objectives in proportion to the material-related overhead costs initially allocated to such final cost objectives.

**§ 419.60 Illustrations.**

(a) Contractor A has a home office material-related function supporting several segments of the company's operations. The costs of this function are allocated to the segments as separately identified home office expenses. Although the allocations are significant in amount, they are included with each segment's G&A expense pool for allocation to final cost objectives. Pursuant to paragraph 419.50(a)(2) of this Standard and 4 CFR 410.50(g), "Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives," the separate allocations identified as material-related overhead costs must be included in the segment's material-related overhead costs for allocation to final cost objectives.

(b) Business Unit B includes the costs of its shipping function in its single material-related overhead pool. The base used to allocate these combined costs is determined to be the same that would be appropriate for allocating the costs of the shipping function and material-related overhead costs separately. Shipping is a function at the end of the production process and is not a material-related function as this term is defined in this Standard. In accordance with the provisions of § 419.50(a)(3), Business Unit B may continue this practice since the costs of other functions may be included with material-related overhead costs for allocation purposes where such costs can be appropriately allocated on the same base used for the material-related overhead pool.

(c) Business Unit C has a significant dollar amount of goods which are shipped directly from the manufacturer or supplier to the designee of Business Unit C and which are not received or handled by the Business Unit. The Business Unit has detailed specifications for the goods to be manufactured, and it maintains a source inspection for the goods. Business Unit C allocates the costs of the source inspection directly to final cost objectives, and accumulates the other material-related costs into two overhead pools. One pool covers only the purchasing function, because it applies to all material acquisitions including drop shipments, and is allocated on a material cost base consisting of all materials acquired. The other pool contains the costs of all material-related functions that do not pertain to drop shipments and is allocated on a material weight base. In both cases, the allocation base used reasonably represents the beneficial or causal relationship of the material-related functions. This practice is in compliance with § 419.50(b) of this Standard.

(d) Business Unit D, as a normal part of its purchasing operations, procures significant amounts of materials and research and development by subcontract. The material-related overhead costs, including those for subcontracted items, are grouped in a single material-related overhead pool. The allocation base for this overhead pool is direct material costs except that costs of individual subcontracts in excess of $500,000 are excluded from the base. To include all costs of subcontracted materials in the base would result in allocations to final cost objectives that are disproportionate to the use of the material-related functions. In accordance with this Standard, Business Unit D must either find an appropriate base pursuant to § 419.50(c) or establish more than one cost pool as provided for in § 419.50(b).

(e) Business Unit E groups all material-related overhead costs into one overhead pool and allocates the pooled costs on the basis of the cost of materials acquired. In the contractor's operations, materials procured by major subcontracts do not benefit from or cause costs of receiving and subsequent material-related functions proportionate to their base element. In addition, the material-related overhead costs associated with major subcontracts is a significant portion of total material-related overhead costs. Under these circumstances, the provisions of this Standard do not permit a single material-related overhead pool. Business Unit E must establish more than one material-related overhead pool in accordance with § 419.50(b).

(f) Business Unit F has a significant volume of Government-furnished materials on a recurring basis. The Business Unit has two material-related overhead pools, both of which are allocated on a direct material cost base. One overhead pool is for the costs of the purchasing function, which performs little effort in behalf of Govern-

ment-furnished materials, and is allocated on the basis of the cost of direct material purchased. The second overhead pool contains the costs of receiving and subsequent material-related functions which perform significant effort on Government-furnished materials. The direct material cost base for this second overhead pool includes the prices that have been agreed to by the contracting officer of the Government-furnished materials. This practice is in compliance with § 419.50(c)(2).

(g) Business Unit G has one material-related overhead pool and uses number of units of material as an allocation base. A recently-awarded contracts calls for three different subassemblies to be acquired by several contracts. Acquiring materials by subcontract is a nonrecurring activity. Because of the nonrecurring nature of subcontracting and the disproportionate allocations resulting from a single overhead pool in this situation, Business Unit G negotiates with the contracting officer a special allocation for application to the special subcontracted materials. This practice is in compliance with § 419.50(d)(2).

**§ 419.70 Exemptions.**

This Standard shall not apply to contractors who are subject to the provisions of Federal Management Circular 73-8 (Cost Principles for Educational Institutions) or Circular 74-4 (Principles for Determining Costs Applicable to Grants and Contracts with State and Local Governments).

**§ 419.80 Effective date.**

(a) The effective date of this standard is —— (reserved).

(b) This Standard shall be followed by each contractor on or after the start of his next cost accounting period beginning after the receipt of a contract to which this Cost Accounting Standard is applicable.

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## PART 420—ALLOCATION OF MANUFACTURING, ENGINEERING AND COMPARABLE OVERHEAD COSTS

Sec.

420.10 General applicability.
420.20 Purpose.
420.30 Definitions.
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420.50 Techniques for application.
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420.80 Effective date.

AUTHORITY: Sec. 719 of the Defense Production Act of 1950, as amended, Pub. L. 91-379, 50 U.S.C. App. 2168.

**§ 420.10 General applicability.**

General applicability of this Cost Accounting Standard is established by Section 331.30 of the Board's regulations on applicability, exemption, and waiver of the requirement to include the Cost Accounting Standards contract clause in negotiated defense prime contracts and subcontracts (4 CFR 331.30).

**§ 420.20 Purpose.**

The purpose of this Cost Accounting Standard is to provide criteria for accumulating manufacturing, engineering and comparable overhead costs, and for allocating the costs thus accumulated to final cost objectives and other specified cost objectives of a business unit based on the beneficial or causal relationship between such costs and such cost objectives. Consistent application of these criteria will improve cost allocation.

**§ 420.30 Definitions.**

(a) The following are definitions of terms prominent in this Standard.

(1) *Allocate.* To assign an item of cost, or a group of items of cost, to one or more cost objectives. This term includes both direct assignment of cost and the reassignment of a share from an indirect cost pool.

(2) *Business Unit.* Any segment of an organization or an entire business organization which is not divided into segments.

(3) *Final Cost Objective.* A cost objective which has allocated to it both direct and indirect costs, and, in the contractor's accumulation system, is one of the final accumulation points.

(4) *Overhead Pool.* A cost pool used to accumulate the indirect costs of a productive function or productive activity.

(5) *Productive Activity.* A manufacturing operation, such as machining, assembling and heat treating in the manufacturing function; an engineering operation such as designing, drafting, testing and evaluating in the engineering function; and comparable opertions such as base maintenance and support, communication services, training, and field engineering and technical services.

(6) *Productive Function.* A productive activity or a group or related productive activities such as manufacturing and engineering.

**§ 420.40 Fundamental requirement.**

(a) Manufacturing, engineering and comparable overhead costs of a business unit shall be grouped in one or more overhead pools for allocation to final cost objectives and other cost objectives as set forth in § 420.50(d)(1). More than one overhead pool is necessary where the manufacturing, engineering and comparable overhead costs in a single pool are not allocated in reasonable proportion to the use of the separate productive functions or activities by the final cost objectives and other specified cost objectives.

(b) The overhead costs in each pool shall be allocated by means of a base which allocates the costs in reasonable proportion to their beneficial or casual relationships to the final cost objectives and other specified cost objectives.

**§ 420.50 Techniques for application.**

(a) *Number and Type of Pools.* (1) A business unit may group its overhead costs in a single overhead pool if:

(i) It performs only one productive function (e.g. manufacturing) and the productive activities of that function are performed in about the same proportions on cost objectives; or

(ii) It performs two or more productive functions but one of the functions (e.g. manufacturing) constitutes the primary function, the other function(s) (e.g. engineering) is in support of the primary function, and the productive activities of the primary function are performed in about the same proportions on cost objectives.

(2) A business unit shall group its overhead costs in productive function overhead pools if the business unit performs two or more productive functions (e.g. manufacturing and engineering) disproportionately on cost objectives.

(3) A business unit shall group its overhead costs in productive activity overhead pools if the business unit performs several productive activities (e.g. machining and assembling) of a productive function disproportionately on cost objectives. The overhead costs applicable to two or more such productive activities, however, may be combined it the resultant allocation to cost objectives is substantially the same as if the costs of each productive activity were allocated by separate pools.

(4) Where predetermined rates are used in allocating overhead costs, significant amounts of variances of a cost accounting period shall be allocated to the benefiting cost objectives in proportion to the overhead costs initially allocated to such cost objectives.

(b) *Composition of a Pool.* (1) An overhead pool of manufacturing, engineering or comparable overhead costs shall include the following:

(i) Costs specifically identified with the appropriate overhead pool(s).

(ii) Costs allocated to the appropriate overhead pool(s) from other indirect cost pools.

(iii) Expenses of a home office associated with specific functions or activities separately allocated to a segment.

(2) An overhead pool shall exclude the costs related to special facilities (e.g. wind tunnels, space chambers and reactors) whose total operating cost is material in amount and which is used in the production of goods or services on some, but not all, cost objectives to which the pool is allocated. Similarly, an overhead pool shall exclude any other costs which cannot be allocated

by one of the allocation bases set forth in (c) below. These costs shall be accounted for in accordance with 4 CFR 418 (Allocation of Service-Center Costs).

(3) Costs of production management and administration and costs of production support incurred for the common benefit of two or more overhead pools shall be allocated to the appropriate overhead pools.

(c) *Selection and Composition of Allocation Base.* The selection of a particular allocation base for any pool of manufacturing, engineering and comparable overhead costs shall be guided by the criteria set forth below.

(1) *Direct Labor Hour or Direct Labor Cost.* (i) A direct labor hour base or a direct labor cost base shall be used, except as provided in (2), (3) or (4) below. The determination as to which of these bases to use shall take into account whether the costs included in a pool are in the aggregate more likely to be related to direct labor hours or to direct labor costs.

(ii) A direct labor hour base shall include all hours actually worked directly on cost objectives (whether compensated or uncompensated).

(iii) A direct labor cost base shall include the straight-time portion of overtime and shift differential pay. It shall exclude the premium portion of such pay, and other special pay and allowances, such as hazardous duty bonus and foreign duty bonus.

(iv) A direct labor hour base shall be used if a business unit employs a significant amount of purchased labor, and if such labor performs work under the supervision and control of the business unit which is substantially similar to the work of the business unit's own direct labor employees; and uses the business unit's facilities and equipment in substantial performance of their work. The hours worked by the purchased labor shall be included in a direct labor hour base.

(v) A direct labor hour base or a direct labor cost base shall exclude the hours or labor costs of employees lent to other cost objectives of the business unit, to other segments, or to a home office. Conversely, a direct labor hour base or a direct labor cost base shall include the hours or labor costs of employees borrowed from other cost objectives of the business unit, from other segments, of from a home office.

(2) *Machine Hour.* A machine hour base may be used for productive activity overhead pools if the overhead costs are comprised predominantly of facility-related costs, such as depreciation, maintenance and utilities. A machine hour base may be used for a single pool or a productive function pool only if the machines used are similar in the operations performed and are used in about the same proportions on cost objectives.

(3) *Prime Cost or Total Direct Cost.* A prime cost (direct labor and direct material costs) base or a total direct cost (direct labor, direct material and other direct costs) base may be used if the constituent elements of prime costs or total direct costs are in about the same proportions among the cost objectives.

(4) *Physical Output.* An allocation base representing the number of units, weight or volume of physical output of the cost objectives may be used if the business unit produces only homogeneous goods in large quantities.

(d) *Allocation to Cost Objectives.* (1) Manufacturing, engineering and comparable overhead costs shall be allocated to the following cost objectives:

(i) Final cost objectives.

(ii) Goods produced for stock or product inventory.

(iii) Independent Research and Development and Bid and Proposal projects.

(iv) Cost centers used to accumulate costs identified with a process cost system (i.e., process cost centers).

(v) Goods or services produced for other segments of the contractor, and for other cost objectives or service centers of a business unit.

(vi) Construction, fabrication, betterment, improvement, or installation of tangible capital assets.

(2) Where a particular final cost objective in relation to other final cost objectives receives significantly more or less benefit from overhead costs than would be reflected by the allocation of such costs using a base determined pursuant to paragraph (c) of this section, the business unit shall account for this particular final cost objective by a special allocation from the applicable overhead pool(s) to the particular final cost objective commensurate with the benefits received. The amount of a special allocation to any such final cost objective shall be excluded from the overhead pool(s) and the particular final cost objective's allocation base data shall be excluded from the base used to allocate this pool(s).

§ 420.60 Illustrations.

(a) Business Unit A, performing under a number of Government supply contracts, maintains a single overhead pool. Business Unit A performs several manufacturing activities in about the same proportions on its contracts.

Under these circumstances, the use of the single overhead pool complies with § 420.50(a)(1)(i).

(b) Business Unit B maintains a single overhead pool. Business Unit B produces several different types of goods. Business Unit B has some industrial engineering and production engineering activities which support the manufacturing function. Business Unit B's single overhead pool complies with § 420.50(a)(1)(ii) since the engineering activities are in support of the manufacturing function.

(c) Business Unit C maintains a single overhead pool for its production department. Business Unit C has substantial amounts of supply contracts as well as substantial amounts of R&D contracts. Manufacturing and engineering functions are performed disproportionately on the supply contracts and the R&D contracts. Under these circumstances, Business Unit C must, in accordance with § 420.50(a)(2), establish two separate productive function overhead pools for manufacturing and for engineering within its production department so that the disproportionate functions can be appropriately recognized.

(d) Business Unit D, performing under a number of Government contracts and commercial orders, maintains a manufacturing overhead pool. Business Unit D's manufacturing activities are performed disproportionately on contracts and orders in that significant forming, machining and assembling activities are performed on some contracts, but only assembling activities on others. Business Unit D must, in accordance with § 420.50(a)(3), establish separate productive activity overhead pools so that the disproportionate manufacturing activities can be appropriately recognized.

(3) Business Unit E performs significant scientific and engineering studies, including drafting and technical publication activities, on a number of R&D contracts and IR&D projects, and operates a model shop, or a prototype machine shop, in performing these contracts and projects. Business Unit E maintains an engineering overhead pool. All of the engineering activities are performed on such contracts and projects. Some contracts and projects, however, require substantially more scientific and engineering studies, drafting, and use of the model shop than others, but require little technical publication activities, whereas others require a substantial amount of technical publication activities with little of the other engineering activities. Since the engineering activities are performed disproportionately on individual contracts and projects, Business Unit E must, in accordance with § 420.50(a)(3), establish separate productive activity overhead pools so that the disproportionate engineering activities can be appropriately recognized.

(f) Business Unit F performs significant machining and assembling activities on a number of Government contracts and commercial orders. The machining activity is performed on all work, while the assembling activity is performed on only some work. Busi-

ness Unit F maintains a manufacturing overhead pool for these activities. An analysis indicates that if Business Unit F were to establish separate productive activity overhead pools for the different manufacturing activities, the use of such pools would produce substantially the same allocations to cost objectives as those achieved by the current single manufacturing overhead pool. Under these circumstances, Business Unit F is in accordance with § 420.50(a)(3).

(g) Business Unit G, performing under a number of Government prime contracts and subcontracts and commercial orders, has two plants in the same city. Both plants perform forming, machining, assembling and testing activities. The main plant, however, performs under Government contracts, while the other plant performs under commercial orders. Business Unit G maintains two productive activity overhead pools; i.e. a manufacturing overhead pool for the main plant and another manufacturing overhead pool for the second plant. Business Unit G's two productive activity overhead pools comply with § 420.50(a)(3). Assuming the same facts as above except that the manufacturing activities at the main plant are applied disproportionately to the cost objectives. Business Unit G must, in accordance with § 420.50(a)(3), establish separate productive activity overhead pools for the main plant if such pools would produce substantially different allocations from those achieved by the main plant's overhead pool.

(h) Business Unit H uses a direct labor hour base to allocate its engineering overhead costs. Business Unit H incurred 2 million hours of direct labor hours during regular time periods and 300,000 hours of uncompensated direct labor hours during overtime periods. Business Unit H must, in accordance with § 420.50(c)(1)(ii), use 2,300,000 hours as its direct labor hour base. If instead, Business Unit H uses the direct labor cost base, and incurred $100 million in direct labor costs, it should use that amount as its direct labor cost base.

(i) Business Unit I whose cost accounting period is the calendar year, performed overtime work on certain Government contracts in May and June and on certain commercial orders in July and August. This overtime work was necessary to meet an accelerated delivery schedule at the specific request (and Business Unit I had obtained the approval) of Government and commercial customers. Business Unit I charged the premium portion of this overtime pay directly to the applicable Government contracts and commercial orders as part of the direct labor costs. In accordance with § 420.50(c)(1)(iii), Business Unit I must exclude the premium portion of the overtime pay from its direct labor cost allocation base if this base is used to allocate its manufacturing overhead costs.

If instead, Business Unit I uses the direct labor hour allocation base and incurred 30,000 hours of overtime work for which the employees are to be paid at a time-and-a-half rate, the number of hours to be included in the allocation base should be 30,000 hours (on a straight-time basis), not 45,000 hours.

(j) Business Unit J maintains two productive activity overhead pools: (i) an overhead pool for the engineering work being performed at its principal place of business and (ii) an overhead pool for field engineering work at location X. Employees working at location X are paid hazardous duty bonus. Business Unit J uses the direct labor cost base for allocating each of the two productive activity overhead pools, and treats the hazardous duty bonus as part of the allocation base. In accordance with § 420.50(c)(1)(iii), Business Unit J must exclude the hazardous duty bonus from the direct labor cost allocation base for the field engineering overhead pool at location X.

(k) Business Unit K uses the direct labor cost base to allocate its engineering overhead costs. Business Unit K employs a significant amount of purchased labor under the conditions described in § 420.50(c)(1)(iv), and treats the costs of such labor as "other direct costs." In accordance with the above cited provisions, however, Business Unit K must use the direct labor hour allocation base so that the hours worked by the purchased labor can be appropriately included in the base.

### § 420.70 Exemptions.

This Standard shall not apply to contractors who are subject to the provisions of Federal Management Circular 73-8 (Cost Principles for Education Institutions) or Circular 74-4 (Principles for Determining Costs Applicable to Grants and Contracts with State and Local Governments).

### § 420.80 Effective Date.

(a) The effective date of this Standard is ——————[reserved].

(b) This Standard shall be followed by each contractor on or after the start of his next cost accounting period beginning after the receipt of a contract to which this Cost Accounting Standard is applicable.

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## PART 421—COST ACCOUNTING STANDARD ALLOCATION OF INDIRECT COSTS

Sec.
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421.80 Effective date.

AUTHORITY: Sec. 719 of the Defense Production Act of 1950, as amended, Pub. L. 91-379, 50 U.S.C. App. 2168.

### § 421.10 General applicability.

General applicability of this Cost Accounting Standard is established by Section 331.30 of the Board's regulations on applicability, exemption, and waiver of the requirement to include the Cost Accounting Standards contract clause in negotiated defense prime contracts and subcontracts (4 CFR 331.30).

### § 421.20 Purpose.

The purposes of this Cost Accounting Standard are (1) to provide criteria for the accumulation of indirect costs in indirect cost pools and (2) to provide guidance relating to the selection of allocation measures based on the beneficial or causal relationship between an indirect cost pool and cost objectives. Consistent application of these criteria and guidance will improve cost allocation for those items of indirect cost not covered by a specific Cost Accounting Standard.

### § 421.30 Definitions.

(a) The following are definitions of terms prominent in this Standard.

(1) *Allocate.* To assign an item of cost, or a group of items of cost, to one or more cost objectives. This term includes both direct assignment of cost and the reassignment of a share from an indirect cost pool.

(2) *Indirect cost.* Any cost not directly identified with a single final cost objective, but identified with two or more final cost objectives or with at least one intermediate cost objective.

(3) *Indirect cost pool.* A grouping of incurred costs identified with two or more cost objectives but not identified specifically with any final cost objective.

### § 421.40 Fundamental requirement.

(a) Indirect costs shall be accumulated in homogeneous indirect cost pools for allocation to cost objectives.

(b) Costs accumulated in a homogeneous indirect cost pool shall be allocated by means of a base which allocates the costs in reasonable proportion to the beneficial or causal relationship which exists between a specific indirect cost pool and the cost objectives.

### § 421.50 Techniques for application.

(a) *Indirect cost pools.* (1) To be a homogeneous indirect cost pool, the pool may include only the costs of an activity or activities which have the

same or a similar beneficial or causal relationship to the cost objectives.

(2) Costs of an activity shall be separately pooled whenever there is no other activity which has the same or a similar beneficial or causal relationship to cost objectives.

(3) The costs of an activity may be combined with costs of other activities or other indirect cost pools if the resultant allocation to each final cost objective is substantially the same as it would be if the cost were allocated separately.

(b) *Hierarchy of allocation measures.* (1) The preferred representation of the relationship between the indirect cost pool and the benefiting cost objectives is a measure of resource consumption of the activity or activities represented by the indirect cost pool. When there is a direct and definitive relationship between the activity or activities represented by the indirect cost pool and the benefited cost objectives, a single unit of measure shall generally represent the consumption of resources in performance of the activities represented by the indirect cost pool. Measures of resource consumption ordinarily can be expressed in such terms as labor hours, machine hours, or other consumption measures. Accordingly, these indirect cost pools shall be allocated by use of a rate, such as a rate per labor hour, a rate per machine hour, or other consumption rate of the support activity.

(2) Where consumption measures are unavailable or impractical to ascertain, the basis for allocation can be a measurement of the output of the activity or activities represented by the indirect cost pool. Thus, the output shall become a substitute measure for the use of resources where direct measurement of use is impractical. Output can be measured in terms of units of end product produced by the activities, as for example, number of printed pages for a print shop or number of purchase orders processed by a purchasing department.

(3) Where neither resource consumption nor output of the activities can be measured practically, a surrogate shall be used to measure the resource used. Surrogates used to represent the relationship generally measure the activity of the cost objective receiving the service and should vary in proportion to the services received. An example of a surrogate base may be number of personnel served by a personnel department. Number of personnel served may reasonably represent the use of resources of the personnel function for the cost objectives receiving the service, where this base varies in proportion to the services performed.

(4) Indirect cost pools which cannot readily be allocated on measures of specific beneficial or causal relationship generally represent the cost of overall management activities. Such costs do not have a direct and definitive relationship to the benefiting cost objectives. These costs should be grouped in relation to the activities managed and the base selected to measure the allocation of these indirect costs to cost objectives should be a base representative of the entire activity managed. For example, the total cost of plant activities managed might be a reasonable base for allocation of general plant indirect costs. The use of a portion of a total activity, such as direct labor costs or direct material cost only, as a substitute for a total activity base, is acceptable only if the base is a good representative of the total activity being managed.

**§ 421.60 Illustrations.**

(a) Contractor A accumulates costs of activities relating to building depreciation, building maintenance, and heat and light in separate accounts. Inasmuch as each activity has the same or a similar beneficial or causal relationship to the cost objectives occupying space, Contract A combines the costs accumulated in the three accounts into one indirect cost pool for allocation to these cost objectives. Contractor A's practice is in compliance with provisions of § 421.50(a)(1).

(b) Contractor B has all its operations in one building. Three indirect cost pools are used to accumulate indirect costs for allocation to final cost objectives; a general administrative pool, a manufacturing overhead pool and an engineering overhead pool. Occupancy costs are accumulated and included in the manufacturing overhead pool. Occupancy costs benefit all three functions for which the contractor has established overhead pools, whereas the other activities in the manufacturing overhead pool benefit only the manufacturing function. Therefore, occupancy's relationship to final cost objectives is different from the relationship of the other activities included in the manufacturing overhead pool. The costs of occupancy must be separately pooled for allocation to cost objectives (see § 421.50(a)(2)). However, if the resultant allocation to each final cost objective would be substantially the same with occupancy costs included in the manufacturing overhead pool, then, as provided for in § 421.50(a)(3), Contract B may continue his present practice.

**§ 421.70 Exemptions.**

None for this Cost Accounting Standard.

**§ 421.80 Effective date.**

(a) The effective date of this Standard is [reserved].

(b) This Standard shall be followed by each contractor on or after the start of his next cost accounting period beginning after the receipt of a contract to which this Cost Accounting Standard is applicable.

AUTHORITY: Sec. 719 of the Defense Production Act of 1950, as amended, Pub. L. 91-379, 50 U.S.C. App. 2168.

ARTHUR SCHOENHAUT,
*Executive Secretary.*

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